

Debt Targets Built on Quicksand

A Critique of the N K Singh Committee Report

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Despite being an improvement on the ad hoc and restrictive Fiscal Responsibility and Budget Management framework, the N K Singh Committee report suffers from some shortcomings. A short critique of the report's framing is presented, suggesting that the report is insufficiently attentive to the considerations of macroeconomic coordination. There is a case for increased fiscal spending that runs counter to the recommendations of the committee.

Fiscal deficits are back in the news. After several years, questions are being posed about the correct posture towards government expenditure. In March 2016, a committee of distinguished public servants reviewed the framework of the Fiscal Responsibility and Budget Management (FRBM) Act, 13 years after it was launched. The purpose was to think about the act and to frame new rules as a result. The N K Singh Committee report (FRBM-RC 2017) received little attention, coming as it did on the heels of the demonetisation decree two months earlier, and would certainly have commanded more notice in another time. It has nevertheless come back into public prominence in the recent past, given the discussion of fiscal stimulus being considered by the current government. There has been a near universal sense of panic about this impending change in stance in the business papers (see, for example, Chakravarty 2017) and many point to the N K Singh report as being a guide for this discussion. This, despite several news items that point to a serious slowdown in the economy. Here, a short critique of the report's framing is presented. It is suggested that, at this juncture, there is indeed a case for fiscal spending that runs counter to the recommendations of the committee.

Perhaps, the most appealing aspect of the report is its suggestion to repeal the FRBM Act. On this, it is on firm ground. There is now, by and large an understanding that an ad hoc reduction of the fiscal deficit to 3% of gross domestic product (GDP) has no reasoned argument behind it and cannot really be followed when there are exigencies such as those that occurred during the global financial crisis. Having noted this, the

committee suggests its own set of policies that are problematic.

Conceptual Shortcomings

First, the report suggests long-term policy rules without any reasoned intrinsic notion of debt sustainability, resulting in an ad hoc framework. Second, the recommendations of the report are built on quicksand; they suggest a target that cannot be easily achieved using the instrument it chooses. Third, the analysis of the committee is silent on the fact that the variables that underlie much of the analysis (the fiscal balance and interest rates) must jointly be determined by macroeconomic concerns of achieving full employment and price stability, and that focusing on such variables in the service of debt management alone will lead to macroeconomic feedback effects that may not be planned.¹ Here, I make the case—even on its own terms, and especially given the current macroeconomic situation in October 2017—for more expansionary fiscal policy.

In this article, I do not focus on the (mild) controversy around whether to favour primary deficit, revenue deficit or the level of debt-GDP as a policy rule. Although this discussion was the most commented on, all the recommendations went in favour of reducing spending, with little or no clarity as to why this was the default setting given the many reasons why increasing spending may be desirable at the current juncture. Neither do I address the useful discussion of the state-level deficits that take up a substantial part of the report.

The fact that the main thrust of the report is towards consolidation suggests that despite the care that went into the report, the recommendations of the committee reflect a perhaps unconscious commitment to a particular viewpoint—that of the bondholder, and even more so, the view of standard international finance—and takes at best a partial view of the issues that ought to be considered. Things can only go in one direction when a report begins with discussions of a “responsible” government, in which responsibility is limited to its payment

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obligations rather than to the needs of the citizenry. Despite some gestures made to the many ways in which government investment may be currently useful, these are forgotten in what follows thereafter. Instead, the report warns about “fiscal adventurism” and its discontents, and the need to be “prudent,” none of which is objectionable, but only if viewed primarily from the lender’s perspective.

Debt as Target

The main recommendation of the committee is that government debt should be a target, set at 60% of GDP by 2023.² It suggests repealing the existing FRBM Act, 2003 and the FRBM Rules, 2004 and enacting a new Debt and Fiscal Responsibility Act in its stead to achieve this. The operational element here is the fiscal deficit that will be adjusted to reach that level. Several reasons are given for adopting a debt anchor but are, on reflection, not completely coherent or convincing.

The committee suggests that in the 21st century “debt is the new anchor” (FRBM–RC 2017: 6) and goes on to say that “debt’, and ‘debt repayments’ are concepts that can be communicated easily to the public, and are also embedded in the psyche of the ordinary citizen.” It is not clear why this level needs to be communicated to the public as an anchor at all. There is no macroeconomic reasoning in which debt levels need to be communicated for stabilisation of any sort. With inflation targeting there is an anchoring to wage demands. Communication only matters insofar as beliefs about the target variable directly influence behaviour and while that is true about inflation, there is no reason to think it is for long-run debt trajectory. In what ways is an announced debt ratio supposed to set expectations, considering that it is a function of the deficit, inflation, the nominal interest rate, and growth, three of which are not under the direct control of the fisc? What are the public at large supposed to do with this kind of information about previously announced debt ratios? How are they supposed to react to it if, say, inflation reduces and the debt ratio is breached? Are they to demand more inflation, less spending, a reduction in interest rates? The behavioural

assumptions are simply not reasoned through.

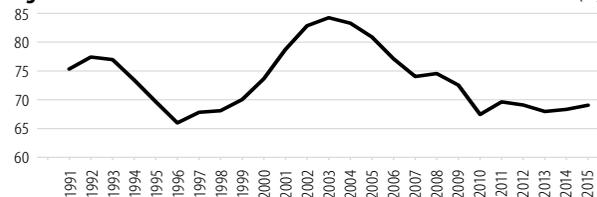
A second reason given is that debt can negatively affect growth. It seems strange to have to relitigate the debates in the United States (US) and Europe surrounding the relationship between debt and growth that consumed the early part of the decade at this late juncture. Suffice it to say that the view that a debt level that caused growth slowdowns could be identified econometrically as the infamous Reinhart–Rogoff paper (2010) attempted to do, has been thoroughly debunked. We have enough evidence that earlier studies had serious problems of reverse causality (see Ash et al 2017, for a conclusive statement) and that there is no evidence that higher debt levels causally affect growth negatively (even in the Reinhart–Rogoff paper, the “dangerous” debt ratio level was at 90%).

The committee makes some half-hearted regression-based attempts at showing that debt becomes dangerous for growth at a break point of around 40%–60% of GDP. I say half-hearted advisedly. In Arvind Subramanian’s useful dissent (FRBM–RC 2017: Annex v), he notes, quite correctly, that the period of the highest growth in India (the mid-2000s) was also exactly the same period in which this limit was breached substantially (Figure 1), and that there is no evidence in support of a danger limit for debt, so it seems that this line of argument does not command consent even within the committee.³

Another motivation appears to be a concern with what might be called “being taken seriously” in an international context. In the committee’s estimation, India does not do “as well” as its comparators in levels of government debt, where low levels of debt are taken to mean “better.” But when one looks at the trends, it is apparent that in some countries, debt ratios have been rising. For example, China has seen a doubling of public debt from 2000 to now, while for India, it has fallen slightly over the same time period.

The bid for seriousness continues to be quixotically pursued when a claim is made for being below 60%–65% of debt

Figure 1: Debt to Gross Domestic Product Ratio (%)



Source: International Monetary Fund.

to GDP ratio so as to remain in the Institutional Investor Rating (IIR) of “intermittent high” range. But as the International Monetary Fund (IMF) itself notes:

In our view, as roll-over risks in India are somewhat mitigated by long average maturities and limited exposure to non-residents, these considerations improve the country’s attractiveness for investors. (IMF 2017: 15)

There is no reason to believe that a target of 60% debt to GDP ratio is necessary for being attractive to investors.

It is puzzling why the committee is as concerned with the level of government debt to GDP ratios currently (and as a result are almost universally in favour of reducing spending going forth). As Figure 1 shows, government debt has fluctuated between 60% and 85% of GDP for nearly 25 years. It is near its historical lows since 1990 at the current juncture (only two years have been lower). Moreover, in this period of growth, the fastest in India’s independent history, debt ratios have never been at the rate suggested by the committee (60%).

Moreover, most debt is rupee denominated, and there is a substantial amount of debt held by the banking sector through regulation. There is only a small fraction of debt that is held externally. The Department of Economic Affairs reports that Indian sovereign debt was \$93.4 billion in 2016, while total debt was on the order of \$1,569 billion.⁴ This suggests that only 6% of debt is held externally and so there is no real sense of facing a hard currency constraint in this regard.

Not only is this the case, it is also clear that since 2007, there has been a substantial reduction in the central government deficits, with deficits now in the 3%–4% range and primary deficits in the 1% range. Why then is there a need for moving to a debt ratio that has never been reached for over 25 years, a period in which India has undergone its fastest period of growth? Certainly, this cannot be because of

some pre-existing externally reasoned choice for debt sustainability.

At some level, there is reason to be sympathetic to the committee. Sustainability of debt is a somewhat ill-defined concept, especially in the context of government debt that does not have a hard currency constraint. The academic literature is of little help in this regard. The No Ponzi game and Transversality conditions that are supposed to bind to maintain sustainability are of no practical guidance⁵ and are regularly violated in the real world (Azizi et al 2012).⁶

An incomplete list of what may be considered sustainable depends on myriad factors, including (i) whether debt is held domestically or abroad; (ii) whether there are capital controls; (iii) whether the debt is denominated in local currency or dollars; (iv) the state of the economy (whether the private sector is in retrenchment); (v) the political economy of central banking (will the central bank purchase large amounts of government debt); (vi) the probability of externally generated macroeconomic instability, and so on.

The question of whether debt is sustainable in that sense is one that is highly contingent. To ward off the obvious response, let me state here that it is not that there are no constraints whatsoever to rising public debt, but the first and most natural limitation is almost always an inflationary constraint rather than a solvency one in countries such as India that have local denominated debt.⁷ One could just as well, and perhaps with more confidence, define fiscal policy actions based on its effects on concrete macroeconomic variables such as inflation or employment/output rather than an arbitrary consideration of non-tangible ideas such as “confidence,” which are far less meaningful as a basis to determine policy.

In the face of the contingent nature of sustainability debt, the committee has responded by valorising an ad hoc number, almost exactly like that in the FRBM. While the FRBM was ad hoc, too low, and the 3% target was never reached, it had the virtue of being something that could be targeted concretely. As the report’s authors are clearly aware, debt dynamics depend on four factors, only one of

which is in the control of the fisc. It is to this question I now turn.

Debt Dynamics and the Implications of the 60% Rule

In the discussion of fiscal policy, the committee rightly focuses extensively on the accounting relationships involved that determine the evolution of public debt over time.

We can formalise this discussion reasonably easily. Purely from an accounting viewpoint, what has been the “least controversial equation in macroeconomic” (Hall and Sargent 2011) states that the debt ratio in each period is equal to the ratio in the previous period, increased by rate of interest, and decreased by the rate of growth of GDP, plus the previous period’s primary deficit. If we let b be the government debt ratio and d the primary deficit to GDP, i be the interest rate on government borrowing and g the growth rate of GDP. The equation can be written as:

$$b_{t+1} = d_t + \left(\frac{1+i}{1-g}\right) b_t \quad \dots(1)$$

The law of motion can be written as:

$$b_{t+1} - b_t = d_{t+1} + \left(\frac{i-g}{1+g}\right) b_t \approx d_t + (i-g)b_t \quad \dots(2)$$

Equation (2) provides the main reason for the concerns of the committee. They note that while d , the primary deficit, has been positive over the last decade or so, i , the interest rate has been lower than g , the growth rate, so that $(i-g)b$ is negative, and thus, despite increased borrowing, the debt ratio has tended to fall. In other words, the main concern is that favourable debt dynamics, understood as the impact of the difference between the rate of interest and the rate of growth have hidden government profligacy thus far and cannot be expected to do so later. The committee worries that the fact that $i < g$ could reverse and points to the recent narrowing of the gap between the two as a sign of potentially a reversion to a “natural” situation where $i > g$. They note, not incorrectly, that all mainstream growth models suggest that $i > g$ in the long-run. But as Delong (2015) notes, many countries, including the US, have somehow stubbornly disregarded the diktats of the long-run model prediction for the last 125 years!

Even in India, there have been periods where the interest rate has been higher than the growth rate, and substantial periods more recently, in which interest rates have been lower than the growth rate. Going forward, which one is likely to persist? I imagine that it would be the latter. India is not the country of 20 years ago where there was a severe lack of credit availability and underdeveloped financial markets resulting in relatively high interest rates. Growth is high, and despite the recent downturn, there is no reason with the demographics that the country has and the potential for expansion that growth cannot continue at the current rates or more. Furthermore, with inflation attenuating, there is no reason to believe that interest rates should not be reduced in the coming few years.

While projections are always to be taken with a large pinch of salt, recent projections from the Organisation for Economic Co-operation and Development (OECD), IMF, and others have India growing at the 7%–8% range for the next few years, while projections of interest rates around 2020 are at around 4%–5%. The committee’s own scenarios use nominal GDP growth of 11.5% and interest rates on central government debt between 7.3% and 7.8% (FRBM–RC 2017: 57). Either way, the broad consensus is for a differential of around 3%–4% between growth and interest rates over the next few years, a point I discuss soon. The Arvind Subramanian dissent note is clear that he expects the $(g-r)$ differential to remain in place for some time. As he puts it, “Both theory and evidence show that a highly positive $[g-r]$ —economic growth exceeding interest rates—is a feature of emerging markets” (FRBM–RC 2017: 166).

If we are interested in the debt–GDP ratio converging to some stable level what should occur with regard to the other variables? We can answer this question by setting the left-hand side of the equation (2) to zero. That gives us:

$$b \approx -d \left(\frac{1}{i-g}\right) = d \left(\frac{1}{g-i}\right) \quad \dots(3)$$

Clearly if $g > i$, as currently and in the projections, then to maintain a stable debt ratio, there is a corresponding stable level of deficit. If, conversely, the situation which the committee fears comes to

pass and there is the situation where $g < i$, then maintaining a constant debt requires a primary surplus.⁸

Here then is the key difficulty: the recommendation to reach and maintain a particular level of debt–GDP is operationally fraught, and will require fiscal to constantly adjust its targeted primary deficit ratio, d , in reaction to variables that are completely out of the control of the fiscal authorities. If one is serious about targeting debt while allowing monetary policy to be flexible, this will mean that the fiscal authority is a passive respondent to monetary policy and we will have created a situation which could rightly be termed “monetary dominance.” Moreover, if the case arises when $g < i$, maintaining a stable debt ratio will be very difficult. In this sense, the proposal is entirely built on quicksand.⁹ Arvind Subramanian, in his dissent, notes further that the framework is problematic “because multiple targets force policymakers to aim at too many, potentially inconsistent objectives and analytical frameworks” (FRBM–RC 2017: 163).

One more point bears noting. As long as the debt ratio is above the target debt ratio, the rule will guarantee that fiscal policy is pro-cyclical.¹⁰ To see why, consider the situation in which there is a negative shock (say from an export collapse) to the economy that reduces growth. From equation (2), it is evident that this will have the effect of raising the debt ratio, necessitating a reduction in the primary deficit further. While there are “escape clauses” in the recommendations, it is not clear when these can come into effect and every negative shock that does not meet the criterion will result in a pro-cyclical deficit. Since the upper bound on debt at 60% is all that is relevant (the report appears happy to have debt fall all the way to zero), this is the more important pro-cyclical effect. If, however, the government wanted a lower bound, then as long as the debt level was lower than this bound, any positive growth would have very low impact on the overall debt and government would increase spending with the cycle.

This simple accounting shows something that is also obvious, but this is completely ignored by the committee.

Debt ratios are dependent on both fiscal and monetary policy, on both the deficit and the interest rate. Having a debt ratio target requires coordination between the fiscal and monetary authorities. In general, the interest rate and the fiscal balance can be thought of as two independent instruments to be assigned to two targets, the path of output and the path of public debt. Mason and Jayadev (2017) show under general assumptions that the same unique combination of interest rate and fiscal balance will be consistent with output at potential and a constant debt–GDP ratio regardless of which instrument is assigned to which target.

In other words, while typically, the fiscal authority is constrained to target a level of debt and the monetary authority target the level of output consistent with price stability (what Simon Wren-Lewis calls the “consensus assignment” [Kirasanova et al 2009]), these could be reversed, with the fiscal authority targeting output and the monetary authority targeting debt. Moreover, Mason and Jayadev (2017) show that at low levels of debt, both assignment rules converge to the targets, but at high levels of debt, the consensus rule (favoured implicitly by the committee) fails to converge and it is better to let the monetary authority target debt. Contrary to conventional wisdom, therefore, the case for countercyclical expansionary fiscal policy becomes stronger, not weaker, when the ratio of public debt to GDP is already high.

It should be noted that this viewpoint is increasingly supported by policymakers elsewhere. In an important article, Jason Furman, the head of the Obama Council of Economic Advisors argued as follows:

The fact that different models find similar results suggests that the idea that fiscal expansion can improve fiscal sustainability is worth taking seriously. And at the very least the real cost of fiscal stimulus is less than the headline numbers would suggest. In some respects, this argument may be even more important in high-debt economies like Japan and Italy. This is because changes in the debt-to-GDP ratio depend on two factors: (i) the difference between interest rates and the growth rate (strictly speaking, r minus g multiplied by the debt-to-GDP ratio) and (ii) the primary balance (the difference between revenue and non-interest spending). The larger the debt is, the more changes in $r-g$ dwarf the primary balance in the determination of

debt dynamics—and so policies that raise g without triggering concerns that raise r by even more can be especially effective in improving sustainability. (Furman 2016: 7–8)

A similar point is made by Delong and Summers (2012) which argues that if there is any significant hysteresis, expansionary policy can full pay for itself, that is, raise growth sufficient to avoid any rise in the debt ratio.

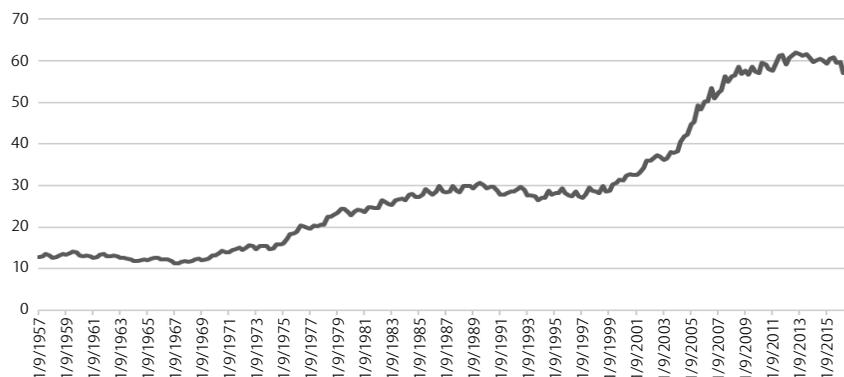
Case for Fiscal Expansion

The Furman and Delong–Summers approach may be equally applicable in India. In a situation where we have substantial debt–GDP ratios and a weakening economy, it makes sense for the monetary authority to reduce the interest burden on debt by reducing the interest rate, and the fiscal authority to target output. In that sense, expanding the deficit and reducing the interest rate will work to both increase output and to significantly improve the debt to GDP ratio since the addition to debt from deficits will be lower than the reduction in debt coming from lowered interest costs. There is substantial place, indeed a necessity for fiscal expansion and interest rate reductions if one is to achieve both the output target and the debt target.¹¹

But even without looking at the question of monetary and fiscal coordination, it is fairly clear that India has much more fiscal space than discussed in the report. What do the numbers discussed thus far suggest about the relationship between the target debt–ratio and the appropriate fiscal stance? We can turn to equation (3) for guidance.

Given a differential between g and i of 3%–4% from our discussion before, holding the current primary deficit of 0.9% at its level would mean that the debt level would mechanically converge to between .009/.03 and .009/.04 or between 22.5% and 30%! This would be substantially lower than the required ceiling of 60%. Put another way, the primary deficit could rise to roughly between 1.8% to 2.4% given the projected differential between growth and interest rates and still be consistent with the mandate for a 60% debt–GDP ratio.

Given these favourable dynamics (that the committee suggests will continue for

Figure 2: Private Non-financial Sector Debt as a Percentage of Gross Domestic Product

Source: Bank for International Settlements (BIS).

the foreseeable future), one might expect the committee not to suggest additional fiscal consolidation, and perhaps even increase spending.

The committee does not suggest this. Instead, given that there is no external bogey in terms of credit risk, we are simply told “domestic defaults happen,” and that inflation is costly. The former may be technically true, but would only be the case if the state actively decided not to fulfil its obligations. It might be worth noting that this has not happened in India’s history. Nor is there any reason for it to occur. A basic fallacy that is common in current macroeconomics is to assume that a government needs to have tax revenue to repay its sovereign currency denominated debt (it does not). The government cannot run out of rupees. The latter concern is a non sequitur. No one is suggesting engineering a high level of inflation to inflate away debt; it is a mechanical collateral “benefit.”¹²

Given this, the report performs a strange pivot to justify less spending. This is most obvious in the otherwise sharp and perspicacious dissent note of Arvind Subramanian. Despite noting that there is no justification for the debt ratio of 60% and further noting that since debt dynamics may be favourable for spending and that growth will be high in the next decade, the dissent note should *reduce* spending steadily so that if there comes a time when the situation becomes worse and headwinds arise (when $i > g$), then we will have fiscal space at that point. It is an opportunity to “fix the roof when the sun is shining” (FRBM–RC 2017: 167). This is, to my view, backwards. There are in fact, *actual* roofs that need to be

fixed and built (the government reports a \$1.5 trillion infrastructural deficit over the next 10 years), and spending is less costly now than it would be when $i > g$, since then the addition to the debt ratio is disproportionately higher, whereas spending when $g > i$ (as is the case currently and potentially for the next decade) will still lead to less debt accumulation. But this preference for lower spending is shared in the main report that also suggested adjusting the fiscal balance downwards steadily over the next few years.

This is a pity, since there is no question that the union could do with additional spending in general. A critical source of expenditure in the country is the government, since private investment has been slowing down in the face of a debt overhang. Indeed, if there is a danger of expenditure slowing because of debt, it is really in the corporate sector, which has seen a sharp increase to about 60% of GDP currently (Figure 2). There is additionally increasing evidence that private debt may be far more destabilising than government debt (Jorda et al 2013; Turner 2016). The committee report does recognise these difficulties, but does not acknowledge the implications for the sources of demand going forward.

Additionally, there is substantial concern that the country has an employment crisis that will make the demographic dividend of a youthful population a demographic nightmare. Nor is there any evidence that we have any macroeconomic overheating. There is increasing evidence that demand is weak as we have slowing wages and very moderate inflation without any monetary policy restrictiveness. Taken together, these suggest

a low-pressure economy with substantial space for expenditure. Just as critically, India is woefully underspending on health, education, and other social sector expenditure, all of which are likely to crowd in private investment. If there is any time to undertake important expenditure, it is now.

NOTES

- 1 This last point is increasingly well-recognised in the literature (Kirasanova et al 2009; Mason and Jayadev 2017; Ryoo and Skott 2012; Bianchi and Melosi 2017).
- 2 For the European Union, this is 60% as well, so this may not be a coincidence.
- 3 Having noted this, Subramanian also suggests that committing to reducing the primary deficit steadily may be the optimal policy, though here again, it is unclear why the natural path should be towards consolidation.
- 4 <https://countryeconomy.com/national-debt/india>.
- 5 In a particularly telling note, the committee shows its general inapplicability to the real world. They note that the No Ponzi condition requires that “the sustainable level of debt should be less than or equal to the PDV of the expected future primary surpluses, where the discount factor is given by $(1-r)^t$, where r is real interest rate on government debt, and g is the real growth rate. This methodology, however, is not easily adaptable to India as India has historically recorded primary deficits, which would imply a negative value of sustainable debt. Second, even the discount factor, or the difference between real interest and growth rates, has consistently been negative” (FRBM–RC 2017: 50–51).
- 6 Willem Buiter (who was consulted for the report) has a wonderful sardonic take on the notion of imbalance and sustainability when he notes: “There is a tendency in the economics profession to regard anything that is not indefinitely sustainable—not in steady state—as an ‘imbalance’. Following this usage, the following would represent imbalances: any positive population growth rate, my life, Life on earth” (2008).
- 7 To further caveat this statement, it is important to realise that, in the Indian context, inflation is predominantly supply led rather than demand led (Balakrishnan 2017).
- 8 Moreover, the stability properties are interesting. If $g > i$, the equilibrium is stable but if $g < i$, it is unstable and if the debt is one rupee too high, it will rise without limit; if it is one rupee too low, it will fall without limit.
- 9 Puzzlingly, the committee report recognises these difficulties but give it short shrift. As they note, “the debt to GDP ratio can be impacted by factors outside the policymaker’s control—eg, interest and exchange rates. Furthermore, it can also be impacted by “below-the-line” items that don’t necessarily flow through the budget. So the link between annual primary balances (the variable most directly under the control of policymakers) and the debt to GDP is not always direct” (FRBM–RC 2017: 34).
- 10 The report recognises this: “In extreme situations, in fact, focusing on a debt target can cause fiscal policy to become pro-cyclical. For example, a negative shock to GDP causes the debt to GDP to rise. If the debt to GDP ratio was already at its limit/ceiling before the shock, the primary balance would need to increase (or the primary deficit be reduced) to improve debt dynamics, thereby making fiscal policy pro-cyclical. But this is only the case when the debt

- to GDP ratio is at its ceiling" (FRBM–RC 2017: 34). The extreme situation, of course, is now.
- 11 Another important concern is that there may be no "shovel ready projects." It is clear that states are not taking up and disbursing allocations efficiently and that actual demand could increase if this was the case. I am grateful to Rathin Roy for specifying this point.
 - 12 Inflation did the most to reduce debt in the US and other countries after the war till the debt build-up beginning in the 1980s (Reinhart and Sbrancia 2015).
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